

26 April 2007



Mr Mike Buckley
General Manager
Network Regulation North
Australian Energy Regulator
PO Box 1199
Dickson ACT 2602

Dear Mike

Powerlink Revenue Reset – Cost of Capital: Bias in the Risk-Free Rate

I refer to the supplementary application from Powerlink on 30 March 2007 seeking to increase the risk free rate parameter in the WAC for the revenue reset by 20 basis points, with a subsequent increase in the revenue determination of some \$30 million.

The EUAA strongly opposes the increase being sought by Powerlink.

Consideration of the appropriate risk free is a complex matter that will have flow on implications for all network service providers. The answer is not black or white and it would be inappropriate to rely on one piece of research work prepared for the entities that would be the beneficiaries of the change. In the short time period available, before the final determination is due, this complex issue can not be given due consideration by either the regulators or other stakeholders. We note that Powerlink does not appear to have taken any steps to help alleviate this problem by providing advance notice to relevant parties.

We further note that the report deals only with the technical aspect of how the Risk Free Rate is derived. It does not address the fundamental issue as to whether there should be a premium on the Risk Free Rate for a regulated monopoly with a guaranteed revenue stream. In addition the affect on revenue comes about by the inter relationship with the inflation rate used for the determination. The recently released figures show an annualized rate of just 2 per cent for the past six months – well below the 3.15 per cent used in the draft determination. If any adjustment is made to the Risk Free Rate then surely it would be essential to use the latest inflation data.

Under the transitional arrangements for consideration of the Powerlink revenue reset, the “new” Chapter 6 Rules will apply in respect of the WACC parameters, ie the AER will not have the flexibility to vary the parameters. If the transitional arrangements have any status, then the correct approach would be for Powerlink to apply for a Rule Change and subject the application to scrutiny and comment by all other relevant parties.

The Risk Free Rate is not the only WACC parameter that is contentious. The EUAA believes that the setting of an equity beta of 1, as currently applied in the draft determination is grossly overstated for a regulated entity with a guaranteed return on most of its assets. The ACCC/AER assigns an equity beta of 1, the average market risk of the Australian stock market, to energy companies. The assigning of the same beta equity risk to a regulated entity with a guaranteed return on assets as applies to the stock market in general is, we believe, not justified. This is just as an important issue as the Risk Free Rate. For instance if an equity beta of 0.9, 0.85 and 0.8 rather than 1 was used in the Powerlink reset, then the revenue for the regulatory period is \$70 million, \$100 million and \$130 million less than that provided for in the draft determination. This would flow through to lower charges. Given the relative amounts involved, and the fact that the level of equity beta is the most contentious of all the WACC parameters any reconsideration of the parameters used in this determination should include the equity beta. If the AER accedes to Powerlink’s application in respect of the Risk Free Rate and does not address the issue of the Equity Beta, the EUAA believes that this would not in any way meet a concept of “fairness” and would be completely contrary to the Single Market Objective.

Finally, I would like to note my concern at the approach that is being adopted by Powerlink in respect of the process for this determination. I realize that we are in a transition period with responsibility for the resets being transferred to the AER from the State regulatory authorities, but this is the second supplementary application submitted shortly before a decision is due. Perception that the revenue determination is being undertaken in an, open, fair and thorough basis is an important element in demonstrating that the system is meeting the objectives that it was designed to do.

If you require further information please contact Robert Davenport on (03) 9898 3900 or at bob.davenport@euaa.com.au.

Yours Sincerely

A handwritten signature in black ink, appearing to read 'Roman Domanski', with a stylized flourish at the end.

Roman Domanski